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July 21, 2003

Senator Jeff Bingaman
703 Hart Senate Office Building
Washington, DC 20510-3102

Dear Senator Bingaman:

On behalf of the State and Tribal Royalty Audit Committee (STRAC), I am writing to thank you for your interest in the Department of the Interior's operation of the Federal Royalty Program. STRAC was encouraged by your response to the recent disclosures by officials of the Navajo Nation of serious instances of "unprofessional" conduct by Federal Royalty Auditors. We agree with your conclusion that Interior's Minerals Management Service (MMS) often acts as a "bottleneck" to the collection and disbursement of royalty income. It appears that the problems are systemic and impact all mineral producing States and Tribes and Congress needs to take a closer look at MMS's "re-engineered compliance review process."

As you know, STRAC is composed of State and Tribal audit managers in jurisdictions that have entered into delegation or cooperative agreements with the U.S. Department of the Interior under the Federal Oil and Gas Royalty Management Act (FOGRMA), as amended, to audit Federal and Tribal royalties in their respective jurisdictions. STRAC monitors Federal and Tribal disbursements to assure that their jurisdictions are receiving their full and fair share of royalty income. STRAC, like its individual jurisdictions, is independent from the Interior Department.

The article in the June 18, 2003 Farmington Daily News focused primarily on the finding by Interior's own Inspector General (IG) that MMS had fabricated an audit of a Navajo allottee mineral lease. MMS is quoted as saying that this event was unintentional and aberrational. While we hope that is true, in our view it is an inexcusable action, which reflects the much larger systemic problems with MMS's current management of the royalty program.

The broader theme of IG Report No. 2003-I-0023 [available at **www.oig.doi.gov**] is MMS's intention to displace royalty compliance audits with their "internal end-to-end or top down compliance review," which is limited in scope. Thus, in its response to the IG's findings,

MMS repeatedly excuses its failure to follow Government Audit Standards by pointing to the resources redeployed to its re-engineering effort. For example, as the IG notes (pp. 12-13):

> The re-engineered process will shift the focus from auditing on a company basis to evaluating expected royalty values on a property basis . . . MMS plans to conduct significantly fewer audits under this process. We believe this may have contributed to MMS auditors being less stringent about adhering to audit standards that they believed would not matter in the future. In fact, at one of our meetings, an MMS Audit Manager clearly stated that he believed MMS would no longer be conducting audits and did not need to be concerned about having an adequate internal quality control system as required by the [Government] Standards.

The sub-text of MMS's responses to the IG is that it was in the midst of implementing substantial improvements to the royalty management program at the time that the IG was conducting its reviews. STRAC does not share MMS's view. Instead, MMS has not only neglected its audit responsibilities – as the IG found – it also has replaced its automated compliance system with an even more flawed system.

When the re-engineering initiative began, STRAC was told that it was aimed at enhancing auditing by providing additional tools for audit selection. The compliance review process, which is essentially a new computer database, would provide auditors with more up-to-date lessee and industry information to facilitate more complete and timely audits. Thus, as MMS explained to STRAC, its new computer capabilities were being designed as "iterative" systems – as new information and findings were revealed through audit of one property, this data would be centralized and circulated to other audit offices, which would theoretically keep all participants in the Federal Royalty Program more abreast of industry changes and trends. Moreover, the re-engineered systems would also be "portable", which would enable more States to assume the expanded program authority Congress granted under the Royalty Simplification and Fairness Act (RSFA) amendments to FOGRMA. It now appears this "re-engineered compliance review" would allow MMS to attest that a larger percentage of properties are in compliance without performing audits.

Initially several STRAC jurisdictions cooperated with MMS by assigning staff to assist in the development of the new systems. Indeed, according to MMS, re-engineering was instigated, at least in part, because of State and Tribal concerns about the quality and utility of the data then being collected and maintained by the agency. Unfortunately, it quickly became clear to the STRAC participants that the systems were not being developed as planned. STRAC repeatedly advised MMS against "over-selling" the re-engineering initiative to Congress and industry. MMS's plan was to make its re-engineered systems operational by October 2001. As that date neared, STRAC asked MMS to maintain the existing computer capabilities in the interim; MMS declined for budget reasons.

MMS's "re-engineered" computer systems currently provides even less reliable and usable data than the prior system. Moreover, as MMS told the IG, MMS envisions that its re-engineered compliance reviews will substantially displace audits, which will reduce the independent reliability of MMS's database even further. Yet, just one day before the IG report was disclosed to STRAC on June 5, 2003, STRAC was given assurances by MMS officials that there would be no changes in audit coverage as a result of re-engineering.

STRAC's access to MMS's database has also been restricted. This, according to MMS, is the result of the Indian Trust Fund Litigation, often referred to as the *Cobell* case. The U.S. District Court in that case expressed concern over the security of trust fund data and, thus, apparently directed MMS to take steps that would preclude hackers from manipulating or stealing Indian Trust Fund data. To our knowledge, there is no allegation in the *Cobell* case that any State or Tribal participant in the royalty audit program has ever lost, misused or manipulated any data relating to any Indian lease. In fact, most of the revenue losses at issue in that case far pre-date the participation of States and Tribes in the Royalty Management Program. State and Tribal participants in the Federal Royalty Program are subject to the same laws on maintaining the confidentiality of reported data as Federal officials and employees.

However, the Court's concerns are being addressed by Interior in a manner that precludes State and Tribal access to data that would be available to the public under the Freedom of Information Act, and that is readily available to MMS and industry. Many States and Tribes will be unable to participate in MMS's proposed "property-based" review or audit plans because they will be denied access to all of the information relevant to the operation of a property. For example, some of the largest producing properties in New Mexico are "mixed" Federal and Indian units. Interior's views on the limitations on State access to information will also make its systems less "portable", which will delay if not dissuade States from assuming the authority Congress extended under RSFA.

STRAC is familiar with the Interior's problems in managing Indian Trust Funds. For several years and well before the lawsuit, General Accounting Office (GAO) auditors assigned to review trust fund issues attended STRAC meetings. This was not simply a result of Tribal membership, but also because of the parallels between Federal trust fund and Federal royalty mismanagement. Congress reacted to Interior's mismanagement of the Federal Royalty Program by extending authority to States and Tribes. Congress logically assumed that States and Tribes would have a more direct interest in overseeing royalty collection. *i.e.*, that the States and Tribes would be less likely to neglect the program and more likely to insist on Federal improvements. In other words, it is obvious, for example, that $100,000 is of far greater financial and practical importance to Silver City High School than it is to a remote Federal agency whose role is to deposit collections into the U.S. Treasury.

Under the path being followed by Interior, STRAC jurisdictions will be getting more inaccurate and less complete information from MMS's automated compliance systems. At the same time, as the IG report demonstrates, there will be less support from MMS for any audit program. MMS is effectively re-organizing its State and Tribal auditors out of the Royalty Management Program. In our view, the *Cobell* litigation counsels against Interior monopolization of any revenue collection and disbursement program.

STRAC believes that the issues I covered above deserve to be elevated and addressed by Congress, or by any investigative services available, like the General Accounting Office (GAO). Members of STRAC would also be a good source for information relating to these issues. STRAC would appreciate you sharing this letter with your other colleagues on any relevant oversight Committee. Thank you again for your interest and attention.

Sincerely,

Jay C. Norman
STRAC Chairman

United States General Accounting Office

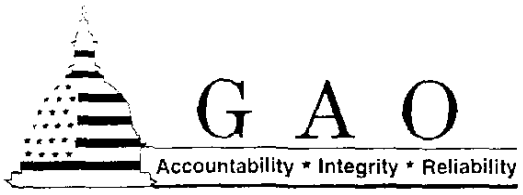
GAO

Report to Congressional Requesters

January 2003

MINERAL REVENUES

A More Systematic Evaluation of the Royalty-in-Kind Pilots Is Needed



GAO-03-296

January 2003

GAO
Accountability · Integrity · Reliability

Highlights

Highlights of GAO-03-296, a report to Representative Nick J. Rahall, Ranking Minority Member, House Committee on Resources, and Representative Carolyn B. Maloney

MINERAL REVENUES

A More Systematic Evaluation of the Royalty-in-Kind Pilots Is Needed

Why GAO Did This Study

In fiscal year 2001, the federal government collected $7.5 billion in royalties from the sale of oil and gas produced on federal lands. Although most oil and gas companies pay royalties in cash, the Department of the Interior's Minerals Management Service (MMS) has the option to take a percentage of the oil and gas produced and either transfer this percentage to other federal agencies or to sell this percentage itself—known as "taking royalties in kind." GAO reviewed the extent to which MMS has taken royalties in kind since 1995, the reasons for taking royalties in kind, and MMS's progress in implementing management control over its Royalty-in-Kind Program.

What GAO Recommends

GAO recommends that MMS clarify its strategic objectives for the Royalty-in-Kind Program and link these objectives to statutory requirements. GAO also recommends that MMS gather key information to monitor and evaluate the program prior to further expansion of the program. In commenting on the draft report, the Department of the Interior generally agreed with GAO's observations and recommendations and emphasized MMS's future plans to improve management control over the Royalty-in-Kind Program.

www.gao.gov/cgi-bin/getrpt?GAO-03-296.

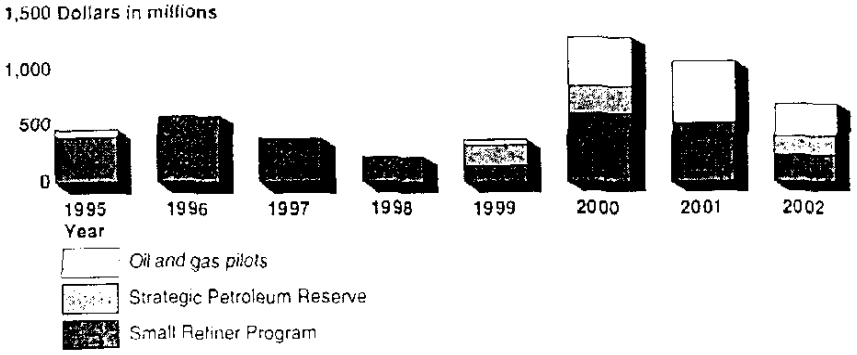
To view the full report, including the scope and methodology, click on the link above. For more information, contact Jim Wells at (202) 512-6877 or wellsj@gao.gov.

What GAO Found

From January 1995 through September 2001, the Minerals Management Service (MMS) took, in kind, 178 million barrels of oil and 213 billion cubic feet of gas, or 32 percent of the federal government's royalty share of all oil and 3 percent of the federal government's royalty share of all gas produced on federal lands. MMS sold the majority of this oil—143 million barrels—to small refiners in accordance with long-standing legislation. MMS also took 29 million barrels of federal royalty oil to fill the Strategic Petroleum Reserve. MMS took the remaining 6 million barrels of oil in kind and all the gas in kind under a series of pilot projects to evaluate whether there are additional circumstances under which taking royalties in kind is in the best interest of the federal government.

MMS personnel have made progress in implementing some components of management control for its Royalty-in-Kind Program, such as addressing the risks associated with oil and gas sales and developing written procedures. However, MMS does not plan to complete and implement all management controls until 2004, when it will consider the Royalty-in-Kind pilots to have changed from a pilot stage to a fully operational stage and when it will have acquired additional systems support. To date, MMS has not developed clear strategic objectives linked to statutory requirements nor collected the necessary information to effectively monitor and evaluate the Royalty-in-Kind Program. Without clear objectives linked to statutory requirements and the collection of necessary information, MMS cannot systematically assess whether Royalty-in-Kind sales are administratively less costly, whether they generate fair market value or at least as much revenue as traditional cash royalty payments, and thus whether MMS should expand or contract the Royalty-in-Kind Program.

Estimated Value of Federal Royalty Oil and Gas Taken in Kind by Purpose, Calendar Years 1995 through 2001 and January through July 2002.



Source: GAO's analysis of MMS data

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Figures

Abbreviations

DOE	Department of Energy
GAO	General Accounting Office
MMS	Minerals Mangement Service
RIK	*Royalty-in-Kind*
SPR	*Strategic* Petroleum Reserve